Expansion and Contraction as Seen by a Business Man

By J. V. FARWELL

President, John V. Farwell Company, Chicago

EXPANSION and contraction in volume of business and in credits have always existed in modern times. Human nature is such and conditions of production and consumption are such that there can be no dead level. Unfortunately, these tendencies nearly always run to extremes, so that we usually have, about once in so often, periods of over-expansion, and, as a consequence, we get over-contraction. Many bankers will admit the existence of the first of these extremes, but they are not so ready to admit the second. It seems to me that both are very real, and that in many cases both of these extremes can be prevented.

As the process of expansion is going on, each business sees most clearly the part that applies to its own experience, while the rest of the process is often either unseen or obscure. A business man, either in manufacturing or distributing, comes in contact with the processes of expansion, from the beginning to the end, from the time when the contract is first made to the end when credit is made for financing and the credit given in selling. Over-expansion is pretty sure to occur whenever such contract is made for a larger quantity than a normal amount used by the business concern, or when it runs through a longer period of time in the future than is ordinarily contracted for by the company, or when the contract is made for a price considerably in excess of the cost of production.

The first step in this expansion is caused, as a rule, by the state of mind of the buyer, who thinks he sees a much larger business ahead than the company has ever had before, or who believes that goods are going to be very scarce, as when the war purchases were being made, and that prices are going higher. It is this thought that produces his act of expansion. This thought and this act are often contagious, so that other people take up the idea and a feverish state of mind, like an epidemic, sets in among all buyers, which results in large purchases for delivery running over a long period of time.

HOW BANKERS COULD CHECK OVER-EXPANSION

In the distributing business, for instance, such buying requires at the start very little credit, and necessitates hardly any simultaneous credit expansion. The wholesaler might place an order for one thousand cases of cotton goods to be delivered during six months, beginning three to six months after date of purchase, the seller being sold up until that time. All that the manufacturer has to do is to cover his cotton on the cotton exchange and put up a margin for so doing. The wholesaler puts up no money at all and no credit. In fact, no credit would be required from the banks for, say, sixty to ninety days, when the first shipment of cotton is to be paid for, and no bank credit asked for by the distributer or wholesaler for perhaps six months, when the bill of the first delivery becomes due.

It is obvious, therefore, that while the business man sees expansion both at time of making the contract and at the time when he asks for credit to pay his bill, the banker would know nothing, except in a general way, of the great mass of purchases so made until some time after the contracts were signed, and perhaps not until the bills came due. Bankers are well posted

in a general way only as to what their customers are doing or expect to do. In my judgment, they should always find out from their customers not only what their stock on hand is at a given time, but also what their commitments or advance purchases are, as these commitments are often the source of as great a loss in the case of a falling market as is stock on hand. If bankers asked these questions continually, especially at the period of requiring statements from their customers, they would be in a better position to check over-expansion at the start, by either discouraging purchases or refusing to give the necessary credit or raising the rate of interest charged.

If, in turn, the Federal Reserve Banks were kept in close touch with all these movements through the leading banks and merchants, as is now being done in many centers, this frenzied state of mind could be cooled off, and large contracts for future high prices prevented. The disease would be stopped before it became an epidemic. It is for this reason that it seems to a business man that rates of the Federal Reserve System should be raised just as soon as bankers see this situation of expanding contracts coming on, not when the bill comes due and the customer asks for credit to pay for it. At that time, the banker can do only one of three things: First, grant the credit; second, advise the customer to repudiate the contract, which he would do under the circumstances, and third, let him squirm out as best he can, no matter what the loss. The last course would probably cause many failures.

FEAR CHECKS OVER-EXPANSION

Over-expansion can be prevented only by arousing in the mind of the buyer a fear that if he makes an excessive contract at high prices, he will get into trouble. He has been led to think in a general way that under the Federal Reserve System his bank would always look after him and there could be no trouble. Many told him if a decline in prices did occur, it would come gradually, even though all history tells us that over-expansion breaks suddenly and prices come down sharply. Even with prices raised to three or four times above normal, it was often felt that no merchandising difficulties could arise, for do we not have the Federal Reserve Banks?

Under the old system, before the Federal Reserve Act was passed, every bank had to depend to a great extent on its own resources, and to live or die according to the distance it got from shore in a storm. This restricted the banker's available credit and lessened the merchant's confidence in getting help. Both banker and business man had a very well defined fear of over-expanding.

While the Great War was on, and even after the Federal Reserve Act was passed, no merchant felt like buying a large amount of goods at high prices for long-time future delivery, as no one could tell when it would be over. When it was started, some thought it would last ninety days, some thought it would last one year, and some two or three years, but it was all uncertain, and bankers and merchants stayed pretty close to shore. They were assisted in not buying at high prices by the action of the government in arranging price fixing bureaus.

When the War did end, there were no large contracts outstanding at high prices and it took only three or four months to make the proper re-adjustments. After that, however, merchants and bankers lost not only all the fear which they had had before the Federal Reserve Act was passed, and which formerly produced panics, but also all the fear which existed while the War was on.

NEED OF A PROGRESSIVE REDISCOUNT RATE

As this fear is very necessary to both banker and business man, I am much in favor of the progressive rate of rediscount, so that those who have the disposition to offend will know in advance that they will be heavily penalized. As the phrase goes, that clause "puts teeth in the law" and the one who first over-expands should be bitten first. A level rate puts all in advance in the same category and does not stop over-expansion at the particular source where it has started. Another reason why the progressive rate law should never be repealed is that in many districts in the United States 8 per cent is the normal rate, and 10 per cent not uncommon. Instead of there being a penalty in charging such banks 7 per cent there is a constant inducement left for them to expand. Federal Reserve Banks must have a sliding scale of rates to meet such common conditions.

As this over-expansion did not occur in the case of all banks and in all districts, but with only a certain percentage of the banks in every district, and as some large banks in big districts were just as bad offenders as the small banks in country places, it seems to me obvious that such a law is not only wise but necessary, in order to prevent over-expansion at the real source whenever it may crop out.

INTEREST RATES ONLY ONE CHECK ON OVER-EXPANSION

Perhaps I have laid too much stress on the efficiency of the rate of interest to stop over-expansion. It is only one of the remedies. Bankers themselves will have many instances where they will have to curb banks and merchants who are willing to pay high rates, if only they are allowed to continue in their mad careers. Federal Reserve Banks, more than ever before, will have to hold a tighter rein to stop such careers by flatly refusing to make loans and especially by stating beforehand that they will so act. Only such advance information, inspiring the proper fear, will prevent the first acts of over-expansion, which, if allowed, bring all others in their train with all the consequent disasters.

The solution is in the hands of the banker. If he will get at the facts and use his strategic position in granting or refusing loans and regulating rates of interest, he could check this over-expansion before it becomes dangerous. In saying this, I do not mean that the banker is as responsible as the business man in starting over-expansion, for the business man is the one who acts first. However, the banker often has a broader view of general conditions, not only in this country, but all over the world, and can, therefore, see the general trend of things earlier. It is for this reason that I have at other times contended that the various Federal Reserve Banks should have raised their rate sharply in November and December, 1919, when the large buying movement at high prices began. Instead of doing that, rates then were as low as $4\frac{1}{2}$ per cent for rediscount with the Federal Reserve Banks. This was almost an invitation to buy heavily and certainly would lead an ordinary business man to assume there would be nothing wrong with the credit situation in the near future.

PREVENTION OF INVENTORY SHRINKAGE

The second important process in general expansion takes place when the various business concerns find their excessive bills coming due and are obliged to resort to banks for large loans. As these goods have been

bought in large quantities at high prices, it takes from two to three times a normal loan to carry a given amount of actual merchandise. This is repeated many times all over the country and all down the line through the different processes of manufacturing. The deposits and loans go up and discounts at the Federal Reserve Banks increase. While this paper so discounted is, in one sense, self-liquidating, as the term goes, that is only true insofar as the prices at which goods are bought can be maintained.

If prices go down half rather sharply, as they did in the fall of 1920, it is only one-half self-liquidating, and if the quantities bought at the high prices are far above normal, it may only be one-fourth self-liquidating, because the concern which bought the goods has no normal channels through which the merchandise can be sold. This brings upon the market so-called "distressed merchandise" which is sold regardless of cost or competition, and aggravates still further an already disastrous situation. It is for this reason that the banker should be somewhat familiar with the prices at which goods are bought, as compared with normal prices, before he encourages a merchant to buy, or before he gets the whole economic structure, including Federal Reserve rediscounts, built up on the basis of high prices.

The Federal Reserve Banks have, in my opinion, been very unjustly criticised for raising rates above six per cent, as though the raising of the rates in the spring of 1920 caused all the trouble. My only criticism is that they did not raise them early enough and before all the harm was done by the making of the vast amount of long-term contracts at the highest prices since the Civil War. They had to act some time, and it was better late than never. The inverted pyramid would have toppled over any way, but less damage would have been done by the fall if the base, which was up in the air, had not been allowed to grow so large.

Prevention of Over-Contraction

While nearly every one admits that over-expansion can be checked, all do not agree that over-contraction can be prevented. Many bankers have told me that we must have a thorough liquidation, which means, in the last analysis, that prices must go below cost of production, mills close up, business stop, much of the circulation of credit and merchandise cease, until this thorough liquidation has run its course. Before the days of doctors and the use of remedial measures, it was undoubtedly thought that all epidemics would have to run their course, that nothing could be done but let the people die. In other words, we must have a thorough "liquidation" and death of people. It is well known that a proper mental condition of the patient is often just as necessary as some stimulus to help out the heart action. So in business affairs, proper mental attitude and some assistance from banks and business men generally is necessary to prevent contraction's going the limit. I think that there are often times when it is evident that contraction has about reached the end, and when the mercantile speculation fever at least has gone. At that time interest rates should be reduced before the irreducible minimum has arrived and some inducement made for people to go ahead and do business, so as to bring about a movement of merchandise and a better employment of the great army of unemployed, which always increases greatly during an aftermath of extreme contraction.

The War Finance Corporation has stepped in and done some of this work

during the last nine months with great judgment and success. It is extremely fortunate that we had some such organization to prevent the so-called complete and disorderly liquidation, which some interests seemed to think absolutely essential to better times.

Education the Remedy for Over-Expansion and Over-Contraction

It is evident that the banker and the business man are in a sense trustees of the prosperity of the nation, in that their combined acts, if unchecked, may bring about hard times and unemployment to thousands of men who have no power of decision in starting a movement which will result so disastrously. I say they have no decision in making the start, although, after it is about half way along, the wage earners have much to say when they begin to buy heavily, and, feeling higher and rising cost of living, begin to demand more pay, which, in turn, adds to the price of the manufactured articles.

On the other hand, in times of over-contraction, the business man and the banker have often lost their power of direction and voluntary decision. They are controlled almost entirely by the general populace, which refuses to buy, and by the wage earner, who will not consent to a reduction of his wages commensurate with the changed cost of living and the new world conditions brought about by the collapse of the boom. It seems to me, therefore, that education is needed on both sides, first to prevent expansion from becoming *over*-expansion and contraction from becoming *over*-contraction. Sound common sense and experience will finally be the teachers if expert economists are not.

Currency Expansion and Contraction

By James B. Forgan
Chairman of the Board, The First National Bank of Chicago

As is well known, the Federal Reserve System is the result of the financial panic of 1907. At least, it was this financial crisis that hastened the establishment of a more rational system of issuing currency than had previously prevailed in the United States. To be sure, there had been earlier movements to make possible an automatic expansion and contraction of our currency. As far back as 1902, and probably earlier, there are to be found discussions in regard to our currency at every convention of the American Bankers Association. Long before the Federal Reserve Act was thought of, it was clear to any thinking banker that our whole currency system needed a thorough revision. In 1902 Charles N. Fowler, Charles G. Dawes and Horace White made addresses dealing with the currency problem at the convention of the American Bankers Association. The chief difference of opinion in that day was between the advocates of a highly taxed emergency currency and those of a low taxed credit currency, or, as General Dawes spoke of it, "a system of asset currency subject only to a nominal tax." As a result of this agitation, there was appointed at that meeting, held in New Orleans, a special Currency Committee, a forerunner of the Currency Commission which still exists. The Currency Committee ap-